

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, CA 94015**

PROPOSED REGULATION TEXT¹

Prior Approval of Insurance Rates

RH05042749

October 17, 2005

§2642.7. Lines of Insurance.

(a) Wherever in this subchapter insurance is required to be classified by line, the classification shall be into one of the following categories:

- (1) Fire
- (2) Allied Lines
- (3) Farmowners multiple peril
- (4) Homeowners multiple peril
- (5) Commercial multiple peril
- (6) Inland marine
- (7) Medical malpractice
- (8) Earthquake
- (9) Other liability
- (10) Private passenger automobile liability
- (11) Private passenger automobile physical damage
- (12) Commercial automobile liability
- (13) Commercial automobile physical damage
- (14) Aircraft
- (15) Fidelity
- (16) Glass
- (17) Burglary and theft
- (18) Boiler and machinery.

(b) For purposes of this subchapter, mechanical breakdown and similar insurance covering loss caused by the failure or malfunction of a component or system of a motor vehicle, as described in California Insurance Code Section 116(c), shall be classified as private passenger automobile liability insurance.

~~(b)~~ (c) Any insurer may disaggregate any of the foregoing lines, except homeowners multiple peril, private passenger automobile liability, and private passenger automobile physical damage, into two subcategories, "commodity" and "specialty."

(ed) Specialty insurance shall include:

- (1) Any single policy having an annual premium over \$75,000;
- (2) Any policy having a deductible or self-insured retention of \$100,000 or more;
- (3) Any excess property, excess liability, or umbrella policy, where none of the underlying policies include private passenger automobile liability, private passenger automobile physical damage, or homeowners coverage, or where the underlying policy is written by an unaffiliated insurer and covers at least the first \$500,000 in losses;
- (4) All policies for
 - (A) nuclear risks,

¹ Additions to existing text are indicated by underline; deletions are indicated by ~~striketrough~~.

- (B) pollution legal liability,
- (C) product-tampering, product impairment, or product recall,
- (D) kidnap and ransom,
- (E) political risks,
- (F) professional liability or errors and omissions, including medical malpractice
- (G) directors' and officers' liability,
- (H) boiler and machinery insurance,
- (I) fidelity insurance,
- (J) mortgage guaranty insurance,
- (K) employer liability under the United States Longshoremen's and Harbor Workers' Compensation Act (33 U.S.C. section 901 et seq.), the Jones Act (46 U.S.C. section 688), the Federal Employer Liability Act (45 U.S.C. section 51 et. seq.), or any similar statute,
- (L) excess employer's liability over workers' compensation insurance; and
- (M) Differences in conditions coverage.

(de) Commodity insurance shall include all policies in the line that are not defined in this section as specialty.

§2644.2. Maximum Permitted Earned Premium

The maximum permitted earned premium is calculated as follows:

- (a)
 - (1) projected losses, as defined in section 2644.4,
 - (2) plus projected ~~allocated loss adjustment~~ defense and cost containment expenses, as defined in section 2644.8,
 - (3) plus projected fixed expenses, as defined in section 2644.9,
 - (4) minus projected ancillary income, as defined in section 2644.3,
 - (5) minus fixed investment income, as defined in section 2644.19(a).

- ~~(b) divided by~~
 - ~~(1) 1.0,~~
 - ~~(2) minus the variable expense factor, as defined in section 2644.14,~~
 - ~~(3) minus the maximum profit factor, as defined in section 2644.15,~~
 - ~~(4) plus the investment income factor, as defined in section 2644.19.~~

Stated as a formula:

$$\text{Max Permitted EP} = \frac{\text{losses} + \text{ALAE} + \text{fixed expenses} - \text{ancil income}}{1 - \text{var exp factor} - \text{profit factor} + \text{invest inc factor}}$$

- (b) divided by the maximum denominator, as defined in section 2644.2(c).

Stated as a formula:

$$\text{Max Permitted EP} = \frac{\text{losses} + \text{DCCE} + \text{fixed expenses} - \text{ancil income} - \text{fixed invest inc}}{\text{max denom}}$$

- (c) The maximum denominator means:

- (1) 1.0,
- (2) minus the variable expense factor, as defined in section 2644.14,
- (3) minus the maximum profit factor, as defined in section 2644.15,
- (4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Max denom} = 1 - \text{var exp factor} - \text{max profit factor} + \text{var invest inc factor}$$

§2644.3. Minimum Permitted Earned Premium

The minimum permitted earned premium is calculated as follows:

- (a) (1) projected losses, as defined in section 2644.4,
 (2) plus projected ~~allocated loss adjustment~~ defense and cost containment expenses, as defined in section 2644.8,
 (3) plus projected fixed expenses, as defined in section 2644.9,
 (4) minus projected ancillary income, as defined in section 2644.3,
 (5) minus fixed investment income, as defined in section 2644.19(a).
- ~~(b) divided by~~
~~(1) 1.0,~~
~~(2) minus the variable expense factor, as defined in section 2644.14,~~
~~(3) minus the minimum profit factor, as defined in section 2644.15,~~
~~(4) plus the investment income factor, as defined in section 2644.19.~~

Stated as a formula:

$$\text{Min Permitted EP} = \frac{\text{losses} + \text{ALAE} + \text{fixed expenses} - \text{ancil income}}{1 - \text{var exp factor} - \text{profit factor} + \text{invest inc factor}}$$

(b) divided by the minimum denominator, as defined in section 2644.3(c).

Stated as a formula:

$$\text{Min permitted EP} = \frac{\text{losses} + \text{DCCE} + \text{fixed expenses} - \text{ancil income} - \text{fixed invest inc}}{\text{min denom}}$$

(c) The minimum denominator means:

- (1) 1.0,
(2) minus the variable expense factor, as defined in section 2644.14,
(3) minus the minimum profit factor, as defined in section 2644.15,
(4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Min denom} = 1 - \text{var exp factor} - \text{profit factor} + \text{var invest inc factor}$$

§2644.4. Projected Losses.

(a) “Projected losses” means the insurer's historic losses per exposure, adjusted by catastrophe adjustment, as prescribed in section 2644.5, by loss development, as prescribed in section 2644.6, and by loss trend, as prescribed in section 2644.7.

(b) Projected losses shall be calculated by applying the loss trend factor separately to data from each accident-year in the recorded period. However, ~~for medical malpractice insurance, where the use of claims-made policies predominates throughout the line, projected losses are more appropriately evaluated on a report-year basis; accordingly, for medical malpractice insurance projected losses shall be calculated on a report-year basis, except where occurrence policies predominate.~~

(c) Where an insurer elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer shall, in lieu of the computation of projected losses

specified in sections 2644.5 through 2644.7, tender an alternative computation of projected losses for the specialty category, which the Commissioner shall approve if he or she finds the projection to have been made in a sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected losses computed in the manner specified in sections 2644.5 through 2644.7.

(d) For the earthquake line of business and for the fire following earthquake exposure in other lines, projected losses and defense and cost containment expenses may be based on complex catastrophe models using geological and structural engineering science and insurance claim expertise. The use of such models shall conform to the standards of practice as set forth by the Actuarial Standards Board and that the applicant shall have the burden of proving, by a preponderance of the evidence, that the model is based upon the best available scientific information for assessing earthquake frequency, severity, damage and loss, and that the projected losses derived from the model meet all applicable statutory standards

§2644.7. Loss and Premium Trend

“Loss trend” and “premium trend” is the process by which forces not reflected in historical loss *and* premium data are expected to affect losses and premiums in the rating period.

(a) Loss trend factors shall be established in accordance with section 2646.3 for all insurers writing a given line.

(b) The Commissioner shall, from time to time, adopt trend factors for each line in accordance with section 2646.3. Trend factors shall be based on the exponential curve of best fit, as measured by the coefficient of determination, and as modified by the Commissioner to take into account factors not reflected in the historical data. Loss trend ~~Trend~~ factors shall be developed using industry-wide paid pure premium data. Premium trend factors shall be developed using company-specific data. The company-specific premium data may be adjusted for factors, such as a change in the company’s mix of business, that would also affect the company-specific loss trend and are not reflected in the industry-wide loss data.

(c) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, the Commissioner shall, in accordance with section 2646.3, adopt separate trend factors in accordance with that evidence.

(d) Changes in the law such as that created by *Moradi-Shalal v. Fireman’s Fund Ins. Companies* (1988) 46 Cal.3d 287 can be expected to have a substantial effect on payouts, and consequently the Commissioner shall specify, in accordance with section 2646.3, the manner in which loss data predating *Moradi-Shalal* shall be adjusted in affected lines to take this change in the law into account.

§2644.12. Efficiency Standard

(a) Notwithstanding any other provision of these regulations, projected fixed expenses shall not exceed

(1) the product of

- (A) projected losses, as defined in section 2644.4,
- (B) plus projected ~~allocated loss adjustment~~ defense and cost containment expenses, as defined in section 2644.8,
- (C) minus projected ancillary income, as defined in section 2644.13,
- (D) minus the fixed investment income, as defined in section 2644.19(a).

(2) multiplied by

- (A) the efficiency standard, as specified in subdivision (b) of this section,
- (B) minus the variable expense factor, as defined in section 2644.14,

(3) divided by

- (A) 1.0,
- (B) minus the maximum profit factor, as defined in section 2644.15,
- (C) plus the variable investment income factor, as defined in section 2644.19(b),
- (D) minus the efficiency standard, as specified in subdivision (b) of this section.

Stated as a formula:

$$\text{Max fixed exp} = \frac{(\text{losses} + \text{DCCE} - \text{ancil income})(\text{effic std} - \text{var exp factor})}{1 - \text{profit factor} + \text{invest inc factor} - \text{effic std}}$$

$$\text{Max fixed exp} = \frac{(\text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc})(\text{effic std} - \text{var exp factor})}{1 - \text{profit factor} + \text{var invest inc factor} - \text{effic std}}$$

(b) The Commissioner shall, from time to time, adopt the efficiency standard pursuant to section 2646.3, which shall be expressed as a maximum allowable ratio of historic underwriting expenses to historic earned premiums, which represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers.

(c) The efficiency standard shall be set separately for each insurance line, and separately for insurers distributing through independent agents and brokers, through exclusive agents, and through employees of the insurer not functioning as agents. In setting the efficiency standard, the Commissioner shall determine whether, in the long-term, efficiency will be enhanced and premiums lowered by adopting a separate standard for insurers writing large and small amounts of insurance in the line. If the Commissioner determines that such separate standards would have such long-term effects, he or she shall set the standard separately according to the amount of insurance being written in the line. In lines where the number of insurers employing a given distribution system is, in the judgment of the Commissioner, inadequate for the calculation of a mean that provides a useful efficiency standard, the Commissioner shall adopt a single efficiency standard for that line, which shall apply to all insurers writing in that line regardless of distribution system.

(d) In each category, the efficiency standard shall be set at the weighted mean (weighted by earned premium) expense ratio of insurers in that category. In calculating the average, the Commissioner may exclude insurers for which reliable data are not readily available or which reflect anomalous conditions.

§2644.15. Profit factors

(a) The “maximum profit factor” means

- (1) The maximum permitted after-tax rate of return, as defined in section 2644.16,
- (2) divided by the product of
 - (A) the leverage factor, as defined in section 2644.17,
 - (B) multiplied by the underwriting federal income tax factor, as defined in section 2644.18.

(b) The “minimum profit factor” means

- (1) the minimum permitted after-tax rate of return, as defined in section 2644.16,
- (2) divided by the product of
 - (A) the leverage factor, as defined in section 2644.17,
 - (B) multiplied by the underwriting federal income tax factor, as defined in section 2644.18.

§2644.16. Rate of Return

The maximum permitted rate of return means the risk premium, as defined below, plus the return on long-term U.S. Treasury bonds for the most recent three months.

The Commissioner shall, from time to time, determine, in accordance with section 2646.3, the ~~maximum and minimum permitted after tax rate of return~~ risk premium for property and casualty insurance ratemaking. The ~~maximum and minimum profit factors~~ risk premium shall represent the ~~range of~~ yields on investments in other enterprises presenting risks to investors comparable to property and casualty insurance; ~~minus the return on long-term U.S. Treasury bonds.~~ giving ~~The commissioner shall give due~~

consideration to the competing interests of investors and consumers, and taking into account the fact that insurance is imbued with the public interest and that its purchase is sometimes legally required.

The Commissioner shall, from time to time, determine, in accordance with section 2646.3, the minimum permitted after-tax rate of return. The minimum return shall be set high enough to prevent any undue risk of insolvency and to prevent injury to competition through predatory pricing.

§2644.18. Federal Income Tax Factors

(a) ~~“Federal income tax factor” means 1.0 minus the insurer’s effective prospective federal income tax rate reported in the most recent year for which historical data are available, giving full account to all tax credits and offsets used or available to the insurer. Where there has been a change in tax laws between the recorded period and the rating period, the effective tax rate shall be calculated using the historical data and the tax rules for the rating period.~~

(b) ~~Where the insurer had a net tax credit, or where the insurer had a net tax liability on a net pretax loss, the effective tax rate shall be zero and~~

~~———— (1) if the insurer had a net tax credit, the amount of the credit shall be added, as a positive number, to nationwide projected ancillary income;~~

~~———— (2) if the insurer had a net tax liability, the amount of the liability shall be subtracted from nationwide projected ancillary income.~~

~~(c) Where the insurer’s effective tax rate reported in the most recent year for which historical data are available exceeded 34% and the insurer had a net tax liability on a net pretax profit, the effective tax rate shall be 34% and the amount by which the tax liability exceeded 34% shall be subtracted from nationwide ancillary income.~~

(a) “Underwriting federal income tax factor” means 1.0 minus the prospective federal income tax rate on underwriting.

(b) “Investment federal income tax factor” means 1.0 minus the prospective federal income tax rate on investment income. The prospective federal income tax rate on investment income shall be calculated using the weighted yield, adjusted for investment expenses, computed in section 2644.20 and shall take into account any tax preferences and exemptions for the income from each asset class and from each category of bond issuer.

§2644.19. Investment Income Factors

~~“Investment income factor” means the projected yield, as defined in section 2644.20, multiplied by the sum of~~

~~(a) the reserves ratio, as defined in section 2644.21,~~

~~(b) plus the surplus ratio, as defined in section 2644.22~~

(a) “Fixed investment income” means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

~~*Invest inc factor = yield × (reserves ratio + surplus ratio) —*~~

(2) multiplied by the loss reserves ratio, as defined in section 2644.21,

(3) multiplied by the sum of

(A) the projected losses, as defined in section 2644.4,

(B) plus the projected defense and cost containment expenses, as defined in section 2644.8.

Stated as a formula:

$$\text{Fixed invest inc} = \text{yield} \times \frac{FIT_{inv\ inc}}{FIT_{und}} \times \text{loss reserves ratio} \times (\text{loss} + DCCE)$$

(b) “Variable investment income factor” means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the sum of

(A) the unearned premium reserves ratio, as defined in section 2644.21,

(B) plus the surplus ratio, as defined in section 2644.22

Stated as a formula:

$$\text{Var invest inc factor} = \text{yield} \times \frac{FIT_{inv\ inc}}{FIT_{und}} \times (\text{uep reserves ratio} + \text{surplus ratio})$$

§2644.20. Projected Yield

“Projected yield” means the insurer’s imbedded yield in the most recent year for which investment results have been reported, plus an average of the insurer’s realized capital gains over the most recent five years. Imbedded yield shall be calculated as the insurer’s net investment income, excluding capital gains, divided by the average of the insurer’s start-of-year and year-end surplus and reserves for the most recent year for which investment results have been reported.

(a) “Projected yield” means the weighted average yield computed using the insurer’s actual portfolio and yields currently available on securities in US capital markets. The weights shall be determined using the insurer’s most recent statutory annual statement, and shall be computed by dividing the insurer’s assets in each separate asset class shown on page 2, lines 1 through 9 of the annual statement, by the total of cash and invested assets shown on page 2 line 10. The yields for each asset class shall be based on an average of the most recent 3 months of yields as provided in the Federal Reserve H.15 bulletin and other publications to be determined by the Commissioner. The Commissioner shall, from time to time, establish and review the specific methodology for determining the yields in accordance with section 2646.3.

(b) The bond asset class shall be subdivided by each category of issuer and maturity shown in schedule D, part 1A, section 1 of the annual statement.

(c) The projected yield shall be reduced by investment expenses.

§2644.21. Reserves Ratio

“Reserves ratio” means

(a) the average of the last two years’

(1) loss reserves plus

(2) loss adjustment expense reserves, plus

(3) unearned premium reserves

(b) divided by the earned premium for the most recent year for which data are available.

(a) “Unearned premium reserves ratio” means

(1) the average of the last two years unearned premium reserves

(2) divided by the earned premium for the most recent year for which data are available.

(b) “Loss reserves ratio” means

(1) the average of the last two years'

(A) loss reserves plus

(B) loss adjustment expense reserves

(2) divided by the incurred loss and defense and cost containment expense for the most recent year for which data are available.

There shall be one industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business. The industry-wide numbers shall be the sum of all such numbers taken from the California state page of the statutory Annual Statement for all insurers doing business in California. Adjusting and other expense shall be allocated in accordance with section 2643.6. For lines of business subject to catastrophes, mass torts and other unusual events, the Commissioner shall modify the industry-wide numbers where he finds that they do not provide a reliable estimate of future expectations of the reserve ratios.

§2644.23. Credibility Adjustment

(a) To the extent that the maximum and minimum permitted earned premiums are based upon data that lack credibility, a credibility adjustment shall be made, ~~as appropriate, to projected losses, projected allocated loss adjustment expenses, projected loss development, and projected allocated loss adjustment expenses development.~~

(b) The Commissioner shall, from time to time, specify credibility criteria and ~~appropriate sources of substitute data~~ formulas for determining the credibility weight in accordance with section 2646.3.

~~(c) The credibility adjustment shall consist of adding to the insurer's data sufficient additional data, drawn from an approved source of substitute data, approved in accordance with section 2646.3, to provide a total sample size sufficient to meet the applicable credibility criterion established by the Commissioner.~~

(c) When the loss and defense and cost containment expense data is less than fully credible, in the maximum and minimum premium formulas in sections 2644.2 and 2644.3, the following shall be substituted:

(1)The sum of

(A) the credibility weight, as defined in section 2644.23(b).

(B) multiplied by the sum of

(i) loss, as defined in section 2644.4,

(ii) plus defense and cost containment expense, as defined in section 2644.8.

(2) plus

(A) the difference of

(i) 1.0

(ii) minus the credibility weight, as defined in section 2644.23(b).

(B) multiplied by the complementary loss and defense cost containment expense, as defined in section 2644.23(d).

Stated as a formula:

$$\text{Credibility weight} \times (\text{loss} + \text{DCCE}) + (1 - \text{credibility weight}) \times \text{comp loss DCCE}$$

(d) The complementary loss and defense cost containment expense means

(1) the product of

(i) the trended current rate level premium, as defined in section 2644.24,

(ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(e),

(iii) multiplied by the maximum denominator, as defined in section 2644.2(b).

(2) minus the sum of

(i) the fixed expenses, as defined in section 2644.9.

- (ii) minus the ancillary income, as defined in section 2644.3,
- (iii) minus the fixed investment income, as defined in section 2644.19.

Stated as a formula:

$$\text{Comp loss DCCE} = \text{TCRLP} \times (1 + \text{comp trend}) \times \text{max denom} - (\text{fixed expenses} - \text{ancil income} - \text{fixed invest inc})$$

(e) The complement trend means the annual net trend plus one, raised to the power of the number of years from the effective date of the current rate to the proposed effective date of the proposed rates, minus one.

Stated as a formula:

$$\text{Comp trend} = ((\text{annual net trend} + 1)^{\text{number of years}}) - 1$$

If the number of years from the effective date of the current rate to the proposed effective date of the proposed rates exceeds four, the complement trend shall be the annual net trend plus one, raised to the fourth power, minus one.

(f) The annual net trend is the annual loss trend plus one, divided by the annual premium trend plus one, minus one.

Stated as a formula:

$$\text{Annual net trend} = ((\text{annual loss trend} + 1) / (\text{annual premium trend} + 1)) - 1$$

(g) If the credibility weight is less than 25% the applicant may use an alternative complementary loss and defense and cost containment expense, provided that the alternative is actuarially sound and reasonable in the circumstance.

§2644.24. Trended Current Rate Level Earned Premium

“Trended current rate level earned premium” means the earned premium per exposure for the recorded period adjusted to the current rate level based on subsequent rate changes and further adjusted for premium trend. The trend adjustment shall be calculated by applying the premium trend factor separately to data from each year in the recorded period.

§2644.25. Reinsurance

(a) For all lines and sublines except for those listed in the next subparagraph, ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

(b) For earthquake and for facultative reinsurance with attachment points above one million dollars, the maximum permitted earned premium is calculated as follows:

(1) The sum of

(A) the quotient of

- (i) the projected losses, as defined in section 2644.4,
- (ii) plus the projected defense and cost containment expense, as defined in section 2644.8,
- (iii) minus the projected reinsurance recoverables, as defined in section 2644.26,
- (iv) plus the projected fixed expenses, as defined in section 2644.9,
- (v) minus the projected ancillary income, as defined in section 2644.13,
- (vi) minus the fixed investment income, as defined in section 2644.19(a).

(B) divided by the sum of

- (i) 1.0,
- (ii) minus the variable expense factor, as defined in section 2644.14,

- (iii) minus the maximum profit factor, as defined in section 2644.15,
- (iv) plus the variable investment income factor, as defined in section 2644.19(b).

(2) plus the quotient of

- (A) the reinsurance premium
- (B) divided by the difference of
 - (i) 1.0,
 - (ii) minus the variable expense factor

Stated as a formula:

$$\text{Max permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{recoverables} + \text{fixed expenses} - \text{ancil income} - \text{fixed invest inc}}{1 - \text{var exp factor} - \text{profit factor} + \text{var invest inc factor}} + \frac{\text{reins premium}}{1 - \text{var exp factor}}$$

(3) Reinsurance costs shall only be allowed for ratemaking purposes as set forth in this section if the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided. Additionally, there must be an acceptable transfer of risk in accordance with Statement of Statutory Accounting Principles No. 62.

(c) Maximum fixed expenses shall be calculated using direct projected losses and defense and cost containment expenses.

(d) The fixed investment income shall be reduced by the unearned reinsurance premium and the variable investment income factor shall be reduced by projected reinsurance recoverable reserves.

§2644.26. Reinsurance Recoverables.

“Reinsurance recoverables” means all amounts recoverable from reinsurers for paid and unpaid losses and loss adjustment expenses per exposure, including estimated amounts receivable for unsettled claims and claims incurred but not reported as provided under reinsurance agreements.